

The role of structured finance in the overall funding strategy of the CEE banks. The case of Asset Securitisation

Kazimierz Michal KELLES-KRAUZ

Vienna University of Economics and Business Administration

kelleskrauz@gmail.com

Since the political changes in Eastern Europe took place, banks in this region have experienced a significant reorganization in structure, core activities and business understanding. These changes have led to the development of banking entities which are flexible, open to the new banking perspectives and react promptly to market changes. However, extensively growing Central and Eastern European (“CEE”) markets require financial sources to meet the increasing demand for core banking intermediation. In order to maintain future growth banks will search for funding instruments which allow them to grow without having a balance sheet effect. In this respect structured finance (especially asset securitisation) may be a solution for these banks and also for other institutions looking for diversified funding sources or credit risk mitigants. It is expected that trend to use securitisation structures will gain on importance due to the decrease in the availability of core funding instrument which are currently deposits. CEE banks’ customers are becoming more aware of possibilities on how to allocate their capital efficiently therefore conventional banking and battle for traditional funding sources will become more expensive.

Although, recent market turbulences have significantly reduced the demand for structured finance products in developed economies, the role of these instruments will not lose on importance in the future. The growing sophistication of CEE banking industry will force banks to create products which enable them to attract liquidity by more advanced means. Covered bonds, ECB repurchase agreements and privately placed securitisation transactions can give flexibility towards active balance sheet management in the times of significant liquidity problems. The development organisations like KfW, EBRD, IFC or FMO due to their statutory responsibilities can serve as intermediaries and “market maker” investors.

Keywords: Structured Finance, Asset Securitisation

JEL codes : G21, O16

1 Structured finance

According to Andreas A. Jobst definition: *"all private and public financial arrangements that serve to efficiently refinance and hedge any profitable economic activity beyond the scope of conventional forms of on – balance sheet securities (debt, bonds, equity) in the effort to lower cost of capital and to mitigate agency costs of market impediments on liquidity are covered by Structured Finance"*. The transactions by means of changing the traditional method of financing (lending and deposits), reducing the risk weighted and due to the accounting issues are part of structured finance and are gaining a significant importance in the European market.

The asset securitisation belongs to the group of structured finance transactions and gives an answer for banks, companies or public sector entities facing the liquidity problems especially in emerging markets. In its scope asset securitisation repackages the originated banking receivables and transfers them to the special purpose vehicle ("SPV") which is finally refinanced by the issuance of bond obligations with different risk categories. The notes issued are "backed" by the underlying assets and all the profits resulted under the transferred claims are after the assignment date the rights of SPV. The originating bank ("Originator") have the right to the residual profit ("Excess Spread") which is the remaining amount after paying the coupon on the notes and other senior expenses. Andreas Jobst in his working paper "Sovereign Securitisation in Emerging Markets" sees the following benefits of securitisation for the originating organisations:

- Better asset liability management (the issues of ABS enables to fund new assets)
- Market based valuation of assets
- For emerging issuers securitisation of future flow receivables gives the possibility of entering into a new international market .

Hence, the transformation and fragmentation of asset exposures during the generation of securitised cash flows characterizes the valuable method of splitting the risks associated with the assets to a broader investors range and capital markets .

Naturally the growth in assets requires additional equity. This makes the conventional funding a relatively expensive alternative, whilst the securitisation in its structure enables to diversify the funding sources, reduce the equity involved in the transaction and gives the possibility to increase the business at competitive margins.

2 Banking assets growth in Eastern Europe

The stronger growth of assets in CEE countries is still subject to the economic reforms and determined by the size, maturity and potential of each country [14, p.12.]. These three factors should be analyzed taking into consideration the degree of banking intermediation which translates into the ratio between the total assets of the banking sector and GDP at current prices [14, p.12.]. It represents a more significant number for markets with a higher degree of maturity and economies which have a considerable degree of influence of financial institutions. During the last years the banking assets to GDP ratio has increased in CEE significantly. Below graph depicts the upward trend which gives an indication for liquidity needs of CEE banks in order to fund the future asset growth.

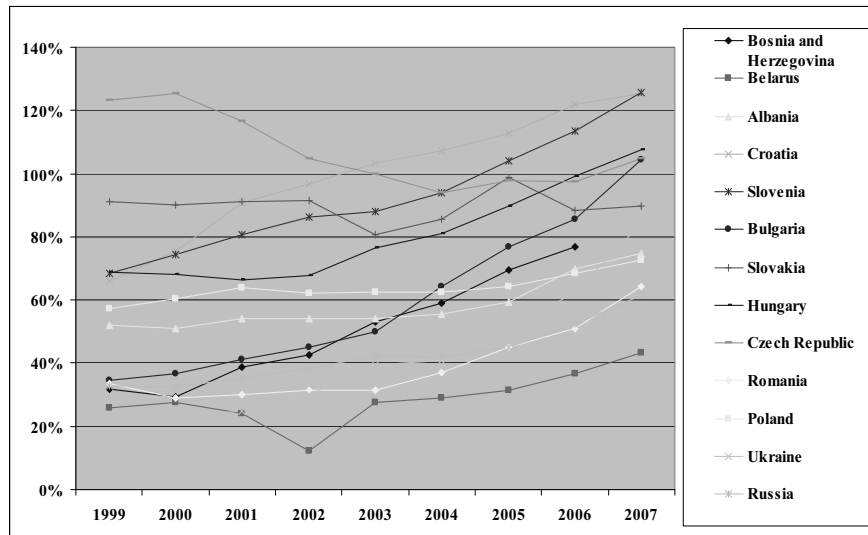


Figure 1
Total banking assets in % of GDP in Eastern Europe
source: own analysis

Taking into consideration the time in which the Eastern countries developed their banking structure and adapted to the new market circumstances and regulations implies the existence of strong competition between those banks and markets. This competition will drive them to seek for the innovative funding methods in order to maintain the current position or to achieve the sustainable market presence.

2.1 Structured finance in developed markets – why CEE now?

As a funding instrument structured finance (e.g. Asset Securitisation) exists in developed countries for more than thirty years. The origin and reason for its growth was connected with increasing demand for loan products, especially mortgage and housing, in United States where bankers firstly recognized the threat of illiquidity [10, p.31.]. The loan originating process was therefore constrained by the availability of funds. This trend was later supported by transformation of commercial banking into more investment banking related activities [5, p.111.]. Based on that reason and also on the competition among originators in reaching the customers, banks acquired the ability of selling the part of their loan portfolio to external investors [5, p.111.]. By that means, apart from the traditional origination, banks started to be involved also on the investor side depending on their origination and underwriting capabilities.

Furthermore, financial intermediation of CEE banks still differ from the EU banking levels, although the banks' ability to collect deposits have improved over the last decade [8, p.26.]. However, comparing to the EU benchmarks, the development of lending in CEE is limited by the less developed capital markets in these countries, what has a negative effect on the traditional banking intermediation [8, p.26.]. Hence, CEE banks in order to maintain the intermediation are forced to seek for funding in more developed capital markets or use credit facilities made available by their parent companies.

Finally, main factors that make structured finance asset securitizations especially attractive for CEE banks compared to banks from more developed countries are as follows:

1. Origination

- a.** Very dynamic growth of assets in CEE region
- b.** Limited possibility to fund the growing origination with on balance methods especially for asset with long maturity e.g. mortgage loans

2. Liquidity

- a.** Capital market of CEE highly dependent on Western investors,
- b.** Deposits become limited funding source and in some cases represent very expensive one¹
- c.** Funding can only be made available through global capital markets. Local market is not sufficient for the growing origination needs

¹ For instance, average deposit account in Ukraine pays interest in range from 12% to 16% per annum.

3. Economics

- a.** Securitisation transactions provide more attractive yields to the investors than “western” deals²
- b.** Asset securitizations open a possibility for arrangers and investors to widen their customer base and to enter into new markets what can be beneficial for their future banking activities
- c.** CEE/CIS banks are looking forward for competitive funding; securitization pricing wise may provide funding on attractive spreads,
- d.** Regulatory issues after Basel 2 implementation give more incentive for CEE banks to securitize certain portion of their assets,
- e.** Mathematically, CEE banks through still higher loan margins contribute to the higher ROE ratios for the part of their portfolios which have been securitized.

4. Innovation

- a.** Asset Securitizations contribute to know-how transfer from arranging to the originating bank, highly beneficial for CEE banks.
- b.** For the purpose of the transaction CEE banks apply their Risk Management, Collections, Origination and Underwriting criteria to the western standards in order to comply with the norms required by the rating agencies,

5. Reputation

- a.** Due to involvement in asset sales deals, CEE banks build their reputation and brand recognition also abroad,
- b.** Brand and marketing reasons for all parties involved

6. Structure

- a.** There is demand for sophisticated products from the CEE banks.
- b.** Reorganization of banking structures in CEE using the “western” models and implementation of solutions already applied by the more developed banks

Asset origination in CEE/CIS represents rapid growing characteristics and is not limited to the one asset class only but is represented in overall growing of CEE economy.

² due to “first time issuer” premium that CEE banks have to pay

3 The changes in banks' funding strategies in Central and Eastern Europe

The quick development of the Central Eastern European banking system to the today's level gives the conviction that CEE banks will promptly adjust their business activities in respect to the new funding sources in order to mitigate the decreasing volume of deposits and to effectively use innovative structured products like securitisation to enhance these activities. Because of more costly interbank capital lending, bounded to the country rating, resulted from the Basel 2 regulations, banks in CEE will search for cheaper funding sources in order to meet the growing market needs in this part of Europe. However the all – in costs for a securitisation transaction may be higher than under traditional funding, the sale of assets provides the banks with the new opportunities to originate more loans in order to transfer them later into standardised repeat deals [7, p.1.]. *Fitch* considers this argument as crucial, once the existence of regulatory reserve requirements made by the national central banks along with the financial covenants on existing debt will encourage the CEE banks to undertake the funding activities without increasing the on balance sheet debt [6, s.5.].

The changes on the bank's liability side include also the growing importance of borrowings but the below investigations will be mostly concentrated on the role asset securitisation will play as a funding instrument.

3.1 The impact of Basel 2 on the banks' funding in CEE

It is likely that the liability side of a CEE bank will be influenced by the introduction of the New Basel Capital Accord. The way banks will acquire funding sources will have to be than adjusted to the new banking environment. It is likely that based on the Basel 2 assumptions and growing liquidity needs bank will search for innovative funding instruments like securitisations in order to remain profitable in their core business activities. In the securitisation transactions, CEE banks belong to the group of originating rather than investing banks due to the fact that the assets are growing quicker than the liabilities and the fact that the Western countries accumulated more capital during the last fifty years than investors from Central and Eastern Europe.

In respect to the above following effects on the banks' funding possibilities can be seen compared to Basel 1 [9, p.11.]:

1. previously banks were divided in OECD and non – OECD banks (20% and 100% risk weighted respectively) and now risk weighting is determined by sovereign rating of jurisdiction or by the bank issuer rating

2. significant change to corporate rating where previously all corporates were weighted 100%
3. Sovereigns, banks, members of OECD countries, had before 0% risk weighting while non- members 100%. Hence the sovereigns and OECD banks claims³ will become less attractive in comparison to the previous situation

The below table show the comparison of the changes in the risk weights in respect to the claims on central banks and sovereigns in the selected Eastern European countries:

Country	Actual risk weighting (B1)	Country Rating S&P	Risk weight in the standard approach (B2)
Poland	0%	BBB+	50%
Czech Rep.	0%	A-	20%
Slovakia	0%	BBB	50%
Hungary	0%	A-	20%

Table 1
Risk weights changes in selected CEE countries under the B2
Source: [3, p.15.]

According to the above numbers, the introduction of Basel 2 result in an increase of funding costs due to the higher interbank capital charges, because of higher equity cost [9, p.70.]. It is therefore likely that for funding and equity relief purposes banks will use structured finance transactions. Thus CEE Originators can undertake three securitisation profiles according to their current preferences. These are as follows:

- synthetic, pure equity relief without funding
 - banks with low funding costs, liquidity not a key issue
- true sale, equity relief plus funding
 - higher risk countries with substantial capital utilization
- true sale, pure funding without equity relief
 - EU member countries, portfolios with low IRB capital utilization

³ This situation is applied for the OECD banks which do not have any external rating allowing them the use of the 0% risk weighting.

According to the above, for rather liquid markets like Poland, the proper transaction strategy would be to undertake the synthetic securitisation in order to release the capital under the Basel 2. The released capital can be re-used as necessary regulatory capital for future origination. Consequently for countries with low rating, funding plus equity relief reflects an optimal link, due to the increase in the risk weights for most of the CEE countries under the New Basel framework. The EU member states with low IRB capital utilization are looking rather for maturity mismatches mitigation and turn to securitisation for the funding purposes. This can be achieved via an initial term take out, meaning the issuance of ABS notes or by setting the warehousing structure which enables the selling of the originated e.g. mortgage assets on the pre-agreed timely basis to the previously established SPV. The issuance of the investment notes will take place after the required pool amount is reached.

Liquidity represents the key challenge for CEE banks, especially in Romania or Bulgaria where Central Banks introduce tough restrictions on the level how fast banks' assets can grow. These banks, by selling the risk weighted assets, bypass these restrictions and increase their origination possibilities as well.

Basel 2 will have an asymmetric impact on banks and portfolios and will contribute to the development of new capital allocation methods. Once the Basel 2 will react in the cost increase of the interbank lending for some of the CEE banks, bounded to the country rating, CEE banks will search for new possibilities how to cost-efficiently obtain funding sources. This Basel 2 implication is especially crucial for CEE banks and it is likely that due to the increase in risk weights CEE banks will take advantage of ABS transactions what will allow them to grow with the competitive funding costs and on improved ROE ratios.

3.2 The increasing cost of deposits

The increasing competition between banks in CEE will also be reflected in customer's consideration where to deposit money subject to the best condition offered by the banking institutions. As the consequence of the growing possibilities given by mutual funds and other asset management companies, ultimately, banks will have to pay more to attract customers to receive their deposits. Also due to the decreasing cost associated with the investing in equities or fixed income instruments, customers will tend to shift their funds in the direction of investment funds where profits are higher than those achieved on depository accounts [13, p.3.]. Nevertheless due to increasing wealth in CEE countries deposits developed moderately during the last years [12, p.15.]. During the liquidity shortages on the financial markets cost of deposits grow significantly also due to the exchange rate fluctuations and increasing lack of

trust towards hard currency. In such circumstances commodities are always the stable mean of securing the wealth, what ultimately translates into higher margins on deposits the banks have to pay in order to attract additional customers.

3.3 How the structured products and especially Asset Securitisation will alter the banks' funding strategies in CEE?

The banks in CEE will face the increasing cost of financing from the financial institutions as a result of changes to the risk weights under Basel 2. Furthermore the decreasing instance of deposits from private individuals and corporates being the cheapest source of bank funding will move the banks towards new methods of acquiring capital. In this respect the increasing importance of Asset Backed Securities coming from Eastern Europe can be expected. Accordingly by transferring the illiquid assets like mortgage loans, which were usually held until maturity, into tradable securities, banks are provided with greater loan origination possibilities as those arising from the on balance sheet self – funding [11, p.64.]. As a result of increased accessibility of securitisation structures and access to the new profits like asset – servicing fees banks will widen their investor base and consequently improve their capital allocation strategies [11, p.64.]. Additionally, by selecting the best assets from the bank's balance sheet and subject to the achieving the superior rating on this pool, banks may reach the better funding cost as they would have reached on the bonds issuance or from the inter-bank loan [11, p.73.].

The funding margins in CEE countries were constantly decreasing aligning with the margins existing in Western Europe until July/August 07 when the “credit crunch” in USA started. This has lead to the conclusion that funding aspect of the securitisation transaction can be of crucial importance mostly in accessing the dis-intermediated⁴ funding sources. Further to that funding achieved via securitisation can be relevant when considering long term maturity mismatches especially observed in mortgage loans. Hence, acquiring funds on the capital markets through securitisation contributes to the following remarks [1, s.35.]:

1. Due to decreasing deposits external funding can lower the funding costs
2. The return on equity will increase

The last point is valid due to less equity requirement necessary as a result of selling part of the bank portfolio and therefore transferring the risk to the third party.

4 Disintermediation occurs when customers decide to withdraw their funds from the depository accounts while searching for higher yield promising investments.

Furthermore, analysing the feasibility of securitisation transactions in CEE against similar transactions from more economic developed countries, it is seen that due to the higher loan margins in CEE, asset securitisation contributes to the higher ROE levels. Comparing to the Western environments, where the Net Asset Margins are usually lower than in CEE, Return on Equity for the same portfolio volume and for the same transaction parameters, represents a lower value.

In addition, for banks with difficult access to cheap conventional funding like deposits, securitisation through effective credit enhancement can provide funding on competitive pricing [2, p.14.]. Using credit enhancement potential buyers reduce their information sensitivity due to the warranty that the seller of assets takes risk associated with default of those assets [4, p.9.]. Hence the quality of underlying assets is guaranteed by the originator what will ultimately positively influence the cost of funding obtained through securitisation.

3.4 Future trends in CEE banks' funding strategies

CEE banks receive currently limited spectrum of possibilities in order to obtain funding for their traditional lending activities due to the liquidity crisis which caused the banks to be more secure in their lending policies. The market for new structured products deteriorated tremendously. The participation of CEE banks on the financial market has been visible before the 2007/2008 crises and its expected that the CEE banks' activities will come back once the market starts to recover. The choice of funding sources will be bounded to several factors as margins, availability, facility size and balance sheet effects. This implies that the selection of funding methods represent an importing task and is already strongly reflected in the internal structure of each bank. During the communist times deposits represented the main source of funding. Nowadays this situation is likely to change in favour of innovative funding instruments but the traditional banking activities should not be affected [4, p.10-11.]. The involvement of CEE banks in various syndication and securitisation transactions along with the growing bond issues affect positively the market perception of financial instruments originated by the CEE banks. This development has to be seen in view of the predictable market, whereas the banks can lend and borrow avoiding the "panic" pricing which can be seen on the current markets.

It is expected that the regulatory capital relief together with expected future decreases in margins will move CEE originators towards the securitisation⁵. This

⁵ It has to be noted that the "recovery" in the banking sector may take many years as the liquidity crisis 2007/2008 represents in the view of many bankers the biggest downturn since the "savings and loans" crisis in the 1980s.

trend reveals a strategy of CEE banks to involve their banking activities in more sophisticated structures. The growing “appetite” of Western investment banks to build a track record in CEE countries will help CEE originators in the negotiation processes. Economics of securitisation will attract the CEE banks to go further in this direction and to use the securitisation structures on the standardised basis. However this development will be subject to the change in regulatory & legal restrictions and also to the improvements in the IT structures which both represent a key issue in the today’s securitisation deals. However, for current developments, the crucial factor is the reopening of the market for the possible deals.

4. Structured finance as funding source during and after the liquidity crisis 2007/2008

This paper represents the forward looking perspective for the structured finance as a mean of banks’s financing. However as current market developments show, it is worth underlining the strategy of CEE banks once the whole banking sector is shaking. The strong usage of securitisations which were based on fake fundamentals being the extensive origination of subprime loans and presumption of constant growing housing prices was in US a warning signal since 2006 already. Nevertheless, the banks have increasingly invested in loan origination activities towards clients which do not meet the bottom lined credit affordability criterias. Once house prices collapsed and defaults among private individuals increased, the securitised bond holders started to be endangered. Accounting principles impose constant valuation of the assets in order that they reflect the current market value. In times of increasing spreads caused by increasing defaults and lowering of housing prices, the investment in securitised assets became below par. Situation has lead to amazing write offs of securitised debt and increasing liquidity problems for many US and Europe banks. The collapse of Lehman Brothers and Fortis bank show how vibrant the markets can be. In such a market circumstances, CEE banks will not be able to place their asset securitisation deals with appropriate pricing among the investors. Today’s yield curve are by far too high for CEE banks which shrink in margins due to rising liquidity costs. As a result, CEE banks will for a period of 2-3 years concentrate on the traditional funding methods like deposits gathering, equity injections or loan taking. It is almost sure that current liquidity crisis will contribute towards more traditional or conservative approach toward assessing the credibility of the customer and also towards accessing the capital markets. Banks will extend their regional coverage and will fight for deposits. Structured finance will be used only with the support of the development organisations like KfW, EBRD, IFC or

FMO which are driven by regional development schemes and not strict business rationale as commercial banks are. Asset Securitisations therefore will for the next 2-3 years be the subject of plain vanilla privately placed deals with above mentioned investors and also with players which have sufficient liquidity to invest. Such investment will contribute higher spreads to the investors as it was before and will be most likely limited only to the friendly or affiliated organisations which support themselves. In the longer time span, structured finance will come back as a funding mean with even stronger impact as before. The structures will be more regulated and deeply rated. This will lead to bigger credit enhancements and higher costs for originators. Nevertheless as markets recover they will tend to fight for instruments which give them additional liquidity needed to fund the business growth as usual business cycle develops.

5 Conclusion

Nineteen years after the democratic changes in Central and Eastern Europe, banking sector in many aspects achieved the quality level of its Western counterparts. Also the awareness of banks clients in CEE towards new banking solutions is similar to Western citizens. Additionally, the involvement of CEE banks in the international money market also represents a growing tendency. In this respect CEE banks had a considerable advantage compared to Western banks in sense they could straight use the ultimate banking solutions bypassing the in-between steps the Western banks had to undertake during the last fifty years.

Banks client searching for higher - yield promising investments will choose investment funds rather than bank deposits once the market recover and people will “re-believe” in the economy. This will lead to banks’ funding shortages for rapidly growing markets in CEE that require funds for their traditional banking intermediation. It will encourage CEE banks to look for external sources of funding like syndications, capital market channels and in future structured products. There will be a strong impact by change from Basel 1 to Basel 2 by influencing the equity requirements of banks subject to their rating. Funding for higher rated banks, have a lower risk weighting, which translate in lower funding cost. The banks with lower rating can bypass higher funding cost by entering in asset transfer transactions. In such transactions the rating of the portfolio is higher than the rating of the bank which translates in lower equity hit. On a macro level the increasing supply of securitisation transactions with higher rated tranches and other alternative funding methods will result in a “flight to quality”.

The use of asset securitisation will continue to play more important role once the long term funding is concerned e.g. mortgage loans or when the equity relief is desired e.g. high risky credit card receivables. At this stage it is crucial to point out that asset securitisation, disregarding all its profits may be difficult to implement by some of the CEE banks due to the sovereign ceiling, missing data history, portfolio size and origination capacities. In this respect funding instrument like asset securitisation may become a method of acquiring funds for already sophisticated CEE banks having potential for future transactions. Smaller banks will absorb funding via more intense participation in syndicated loan market or through bond issues. Nevertheless each involvement in the innovative structure like securitisation brings additional value to the bank representing also a reputation aspect on the highly competitive CEE banking market.

Summing the above arguments, structured finance and especially asset securitisation will affect the banks' funding strategies in Eastern Europe but will have different implications for each CEE bank due to its funding preferences, banks market perception and market share potential. Nevertheless asset securitisation and involvement in innovative structures at acceptable market conditions will lead to modification of the traditional banking activities what in long term will result in changes of the whole banking sector.

References

- [1] Angheben M., "Recent Developments in the European Securitisation Market", <http://www.zse.hr/UserDocsImages/mangheben.pdf>
- [2] Barnes D., Warman N., "Is securitisation still a useful balance sheet tool?", Balance Sheet; Winter 1999/2000; 8, 2; ABI/INFORM Global,
- [3] Basel Committee on Banking Supervision (2004): "International Convergence of Capital Measurement and Capital Standards A Revised Framework", Bank for International Settlements, <http://www.bis.org/publ/bcbs107.htm>
- [4] Boot, W. A. and A. Schmeits (1998): "Challenges to competitive banking: a theoretical perspective", http://www1.fee.uva.nl/fm/papers/Awaboot/english/competitive_banking_ResInE.pdf.
- [5] Chew D., "New Developments in Commercial Banking", Basil Blackwell Ltd, Cambridge, Massachusetts 1991,
- [6] Eisinger N., "Securitisation in Emerging Markets", Fitch Ratings, EIB Securitisation Conference, Warsaw 10.05.2007, http://www.eib.org/attachments/general/events/warsaw_10052007_eisinger.pdf
- [7] Elul R., „The Economics of Asset Securitisation”, Business Review, Federal Reserve Bank of Philadelphia, Q3 2005, pp.16-25

- [8] Hagen J. v., Dinger V.: “Banking Sector (Under?) Development in Central and Eastern Europe”, Zentrum für Europäische Integrationsforschung, Bonn 2005,
- [9] ING Investment Grade Strategy & Research (2006): “Estimating the Basel II effect”, ING working paper, 3rd of July 2006,
- [10] Kendall T. L., Fishman M.,: “A Primer on Securitization”, The MIT Press, Cambridge, Massachusetts, London, England 1996,
- [11] Mullineux A., Murinde V., “Handbook of International Banking”, Edward Elgar Publishing, UK 2003,
- [12] Raiffeisen Research: “CEE Banking Sector Report”,Raiffeisen Zentralbank Österreich AG and Raiffeisen Centrobank AG, Vienna Sep.2006,
- [13] Stern G., “Bank Funding. Challenges ahead but no crisis“,The Region, 2001, issue June, pp. 2-4,
- [14] ZEB/EFMA/KBC/Raiffeisen International (2007): “Central and Eastern European Banking Study. <http://www.efma.com/ceeb07/index.php4> Vienna 2007